Public Choice **116:** 91–108, 2003.

Class action extraction?

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Accepted 31 July 2002

Abstract. Class action lawsuits as a vehicle of rent extraction is developed as an extension of political/legislative rent extraction theory. An event study is performed on thirty firms in which a securities class action lawsuit is filed and subsequently resolved by retraction, settlement, or legal verdict. The data set is found to be consistent with rent having been extracted as a result of the class action lawsuit.

1. Introduction

Rent Extraction theory, as developed by McChesney (1997) suggests that politicians are not mere brokers between political interest groups, but are independent political actors with their own claims. Political office confers a property right to impose costs – politicians are able to extract wealth by political extortion, by not imposing costs. In McChesney's words, they get money for nothing. To make this threat effective, occasionally the politician must implement the threat. One way is to increase costs of production, either through taxation or regulation. Alternatively, politicians can legislate price controls to lower the price a producer can receive. In either case, the politician is targeting the capital value of privately created rents.

But an examination of class action lawsuits leads to a similar model of extortion, not political but legal extortion. In this theory, trial lawyers have obtained a conditional property right to impose costs via the class action lawsuit.[1] They have obtained this right bypassing the bar (whereby government restricts competition from others). This is necessary, according to many lawyers, to avoid "the most unwary, guileless members of the public being incompetently represented and advised, if not victimized and defrauded"

* The views expressed in this article are those of the authors and do not reflect the official policy or position of the United States Air Force, the Department of Defense, or the U.S. Government. The authors wish to thank Richard Wagner and Charles Rowley for helpful comments on an early draft.

(Leef, 1997: 1). More importantly, they have obtained this right through legal changes, most notably in 1966 to the Federal Rules of Civil Procedure. These changes allow trial lawyers to sue on behalf of an entire class of "victims" without obtaining their individual consent, rather it only requires "token plaintiffs" (Hensler, 2000: 14). In addition, class action status itself is to be determined independent of the actual merits of the case, an interpretation that was established in the 1974 Supreme Court *Eisen* decision.

The class action lawsuit itself, while allegedly offering benefits in terms of reduced litigation expenses for the legal system, increases the uncertainty for businesses, since a large adverse decision could put them out of business. Rather than "bet the business", most businesses prefer to settle out of court (Priest, 1997: 522). As Priest notes, this gives tremendous leverage to the trial lawyers, since the merits of the case do not matter in class action status, and juries may conclude the facts don't matter as well.[2] As Texas' Attorney General John Cornyn states, "Even in the absence of proof, economic pressures are so great that an industry cannot afford to go to trial. They must, out of necessity, try to settle on the best terms they can" (Fund, 2000: 10).

Given this environment, trial lawyers have the legal right to threaten a company with large losses, which they will not carry out with a suitable up-front settlement – money for nothing. The costs of this extraction can be staggering for the economy as a whole. The American Tort Reform Association (ATRA) has estimated that overall tort costs (of which class actions are just a part) were in excess of $150 billion in the United States for 1994, and costs are increasing at a rate four times faster than economic growth (ATRA website). While undoubtedly much of this cost is a transfer, much is also sheer waste. The opportunity cost of the legal system is whatever the judicial infrastructure (lawyers', judges', clerks', etc., time) could have produced if not involved with class action lawsuits. Some scholars have struggled with the question, "Does the act of certifying a class coerce settlement of frivolous or nearly frivolous claims?" (Willging, 1996: 59). Indeed, as the pendulum has swung against class actions recently, "the fear that certification alone will be determinative of the dispute" has led several judges (sometimes openly) to more aggressively question certification (Priest, 1997: 523).[3] When the Federal Judiciary Center asked this question, they were only able to suggest that class certified cases should settle more frequently if it is the class action status device that coerces settlement. In fact, they found that class action suits were more than twice as likely to settle as cases that contained class allegations but never certified (Willging, 1996: 60). While this is undoubtedly a useful indicator, the theory of legal rent extraction may add to the explanation. As explained above, legal rent extraction posits that class action status is a property right to legally extract wealth. One critical difference between legis-

lative rent extraction and legal rent extraction, however, is that the legislature withdraws the threat upon extraction of the rent. Legal rent extraction reduces significantly the threat, but the reduced threat is carried out, since that is the source of the rent that is extracted.

This questions whether it really is, as McChesney says, money for nothing. It also opens the door for a public interest explanation for settlement. Most trial lawyers suggest public interest reasoning in their advocacy of class action lawsuits. Much of their rationale is based on the required change in conduct on the part of the defendant, or on the ability to correct small harms to large numbers of people. Yet the anecdotal evidence often rejects this explanation. Schonbrun (1997: 51) provides an interesting anecdote, which seems to reject the public interest perspective.

> "In 1988, class action lawyers sued the Mt. Konocti Water Company for overcharging lot owners on their water bills in a Lake County, California subdivision. The court ordered the water company to return $1.2 million, but the company only had $500,000 in assets. The real problem, however, was that the water company was self-insured and owned by the owners of the lots. As a result of the judgment, the water company went into bankruptcy, requiring it to pay over $3 million in attorneys' fees for the settlement and a plan of reorganization. The original plaintiff received $300 as a result of the class action settlement, but will owe $6,000 for the cost of the reorganization."

In this example, the plaintiffs were also the defendants, thus there is no possible public interest story in the lawsuit. The only explanation for this lawsuit was personal remuneration to the class lawyers. Of course this is simply anecdotal evidence, and surely there are a myriad of motives which drive class action lawsuits. Yet if the motive for securities lawsuits is, as is often stated in the public interest view, the shareholder, we should see these lawsuits as wealth creating rather than extracting. This proposition will be tested below. Priest (1997: 547) correctly finds it:

> "Surely a curious circumstance in a country committed to the rule of law to accept the propositions (1) that class certification alone creates great negotiating power, (2) that that power leads to actual settlements, sometimes large dollar settlements, and, simultaneously, (3) that this great negotiating power can be created without any Judicial review of a claim on the merits and, in some cases, without any merit to the claim."

While this is curious from a public interest point of view, from the theory of legal rent extraction, it is easily explained. One would expect class action status to deliver significant benefit to the favored constituency, and this con-

stituency would use it to extract rent, and this extraction would be beyond the review of the judicial system.

2. Why legislative vs. judicial rent extraction?

Most rent extraction has, as its source, the legislator.[4] As mentioned above, the property rights conferred to lawyers were given by the legislature. Why would the legislature confer power of rent extraction to private citizens when they could conceivably extract the rents directly? There are at least two reasons why they would delegate that capability. In McChesney's analysis, he suggests that legislators would be inclined to equate the benefits of rent creation and rent extraction at the margin (McChesney, 1997: 22). This suggests that part of the reason may be that it is more advantageous at the margin to create rents for trial lawyers than to directly extract the rents. Trial lawyers have contributed handsomely to politicians, especially those supportive of plaintiff's right to sue.

In addition, when private parties pay for the right to extract private rents, the extraction is one step removed from the political realm, making it easier for politicians to avoid blame in the aftermath of egregious verdicts. In many of these cases, it would have been impossible for the legislature to extract the rents directly because of political pressures. As Fund (2000: 11) notes, "Several states – such as Alabama and California – whose legislatures explicitly rejected tobacco tax increases proposed by public health groups decided instead to impose a tax through the judicial branch, the courts, rather than the legislature." For particular taxes or regulation (as opposed to general tax or regulation policies), it is often necessary to demonize an industry or company for a political rent extraction to take place. Yet there are many companies/industries with sizable privately created rents that are not easy to characterize in this manner. Specific punitive legislation in these cases might cause an electoral backlash. Yet allowing private citizens to extract the rents through the judicial system may provide sufficient distance from voters with short memories – and still provide funds back to the politician. Legal rent extraction is also possible at the state level. Consider a class action suit filed in state court against an out-of-state manufacturer. While it may be politically difficult for the legislature to attack the wealth of a specific out-of-state company, there is no such prohibition against the legal system. In fact, there are significant rewards to extracting out-of-state wealth. As Tabarrok and Helland (1999) show, in states where judges are elected, there is evidence to support the claim that judges will transfer out-of-state resources to in-state recipients. The motivation is noted by retired Judge Richard Neely:

> "As long as I am allowed to redistribute wealth from out-of-state companies to injured in-state plaintiffs, I shall continue to do so. Not only is my sleep enhanced when I give someone's else (sic) money away, but so is my job security, because the in-state plaintiffs, their families, and their friends will reelect me." (Tabarrok, 1999: 157).

This may help explain the desire of most businesses to federalize tort reform, while most trial lawyers would like to keep it at the state level.

In legislative rent extraction, the legislator can threaten to either increase costs or to regulate the product to extort private rents. In legal rent extraction, the lawyer has similar capabilities, especially through use of the class action lawsuit. The lawyer can significantly raise the costs of doing business via the settlement fee. But many settlements also mandate changes in the business practices, regulating future activity. In fact, the lawyer's fees are often justified by how significant the defendant's business practices have changed (Hensler, 2000: 278). Thus the class action lawyer is able to threaten both increased costs and regulation simultaneously. if the defendant chooses settlement, he will be able to negotiate for lower regulation and reduced costs.

3. History of legal rent extraction

The birth of Rule 23 of the Federal Rules of Civil Procedure occurred in 1938.[5] The changes leading to Rule 23 were comprehensive, concerning civil litigation in general, but included major changes for class action suits. With the changes of 1938, there were three separate types of class actions: true, spurious and hybrid (Hensler, 2000: 11). The most important difference between these categories was whether the action would bind absent parties. According to Hensler (2000: 11), "only "true" class actions could bind absent parties. "Spurious" class actions bound only the class representatives and those absentees who explicitly chose to be bound. "Hybrid" class actions were binding on absent parties in some respects, but not all." Although the motivations driving this change are not known, the rules put in place would guide the course of litigation for over 20 years.

In 1960, the Chief Justice instructed his newly appointed advisory committee to look at all aspects of the Federal Rules, including Rule 23. Resnick (1991: 8) notes that class actions were a significant focus of the advisory committee, which ultimately led to a new version of Rule 23. This radically changed the legal framework for class action lawsuits – the most important change was to allow representative plaintiffs. Subsequently, individuals wanting to opt out of a class action lawsuit would be required to indicate so. Since requiring positive action makes it less likely, we would expect relatively few

people to opt out after the rule change. The Federal Judiciary Center's study reports that less than .2% of qualified personnel opted out of the class actions they reviewed (Willging, 1996). A public choice analysis would argue that these types of rule changes do not occur in a vacuum, but are driven by the incentives of those advocating the changes, including self interest.

John Frank, a member of the Advisory Committee responsible for the 1966 changes to Rule 23 argues otherwise,

> "...the race relations echo of that decade was always in the committee room. If there was [a] single, undoubted goal of the committee, the energizing force which motivated the whole rule, it was the firm determination to create a class action system which could deal with civil rights and, explicitly, segregation. The one part of the rule which was never doubted was (b)(2) and without its high utility, in the spirit of the times, we might well have had no rule at all." (Hensler, 2000: 12).

Miller (1979: 679) echoes this idea, "Hopes were great that the class action would prove instrumental in dispensing justice to socially or economically disadvantaged groups as well as to small claimants generally". Perhaps this truly was the motivation. Yet as critics note, the bulk of the problems with class action lawsuits have to do with section (b)(3) {which allows monetary damages rather than injunctive relief}, having nothing to do with traditional civil rights concerns. Kaplan (1967: 394) responds that "This timid course {eliminating (b)(3)} was unthinkable in the face of the insistent need to improve the methods of handling litigation affecting groups. But Kaplan (1967) acknowledged that the changes could lead to increased litigation, but felt it was worth it to accomplish the goals of the rules changes (Resnick, 1991: 14). Miller (1979: 669) also argues that the intention of the Advisory Committee was not to revolutionize or make major changes to the class action rules. Nonetheless, that is exactly what occurred.

In Resnick's review of the records, she notes a differing reason, suggesting the committee was responding to judges' and lawyers' "impatience" with the confusing tripartite classification of class actions as true, spurious, or hybrid (Resnick, 1991: 8). Although the changes eliminated the old language, they did allow for differing reasons to have a class action suit. But as mentioned above, the significance of these changes was in allowing the establishment of class action status "without consulting the wishes of the absent parties, and the outcomes of the litigation are binding on all class members" (Hensler, 2000: 14). Although individual rights were protected somewhat by the mandate to notify potential plaintiffs of their right to opt out, the change created a bias towards more suits. As critics noted, since the incentives to opt out in many cases were limited, classes were "almost certain to be larger – and the

sum of their potential damages, therefore, much larger – than classes certified under the old rule." (Hensler, 2000: 15).

This change significantly increased the potential payoff of class action suits. Economic analysis suggests that lawyers should substitute among all areas of legal activity until the marginal returns are equal. This suggests that more lawyers would engage in class action suits after the changes to Rule 23. This is consistent with Resnick (1991: 9), who argues that changes were explicitly made to "enable more cases to be certified as class actions." Professor Kaplan, reporter to the Advisory Committee which drafted the 1966 changes, noted that many of the critics of rule 23 (prior to the changes) suggested simply getting rid of it and returning to the rule prior to 1938 – but the committee "thought that a further effort should be made" and the class action should be preserved (Kaplan, 1967: 386).

Even defenders of the 1966 changes, such as Miller (1979: 674), acknowledge that "It is true, of course, that the shift from an opt in to an opt out procedure has heightened the attractiveness of seeking damages".[6] In fact, while empirical examinations of the impact of class action suits during the '70s did not show huge impacts on the legal system, they did show an increasing trend of class action lawsuits at an alarming rate (Hensler, 2000: 18). Class action lawsuits were generally given wide latitude by the courts during this early period, with comments such as "if there is to be an error made, let it be in favor and not against the maintenance of the class action" and the rule "should be given a liberal rather than a restrictive interpretation" representative of thoughts of the day (Miller, 1979: 678).

The additional lawsuits caused great consternation in the business community. Critics suggested that attorneys were pursuing cases that had no legal merit just to generate fees, that benefits to the consumers were next to nothing, and that the Advisory Committee should revisit Rule 23 (Hensler, 2000: 15). William May, the chairman of American Can Company, said "we are fighting for our lives." (Hensler, 2000: 16). This may seem like hyperbole, but the comment was supported by Abraham Pomerantz, then dean of the plaintiff class action bar:

> "Everyone who deals with the public today is open to brand-new areas of litigation. This is driving many corporations to something bordering on hysteria. The big problem for them today is not so much increasing legal expenses – it's the enormously increased legal exposure. That class suit really strikes at the pocketbook. In some cases, the corporation's very existence is at stake." (Hensler, 2000: 16).

Professor Miller, an assistant to the Advisory Committee's reporter (who was present for all the deliberations prior to the 1966 changes), argues that the

changes made in 1966 are not responsible for the explosive growth in class action lawsuits. As he states:

> "In my judgement, Federal Rule 23 is being used as a convenient scapegoat for grievances against our civil litigation system and trends in our society whose roots lie far deeper than the procedural aspects under that rule. Accordingly . . . drastic revision of class action practice at this time, either by legislation or rulemaking, would be tantamount to attempting a cure by treating one symptom of an ailment rather than dealing with its underlying cause (Miller, 1979: 668)."

Miller (1979: 669) argues that many societal changes were underway contemporaneously leading to the results seen in the class action field, "the changes actually reflect the demands of variegated societal pressures unrelated to Rule 23 . . . Given the nature of these forces, however, the situation would have been much the same . . . had Rule 23 not been touched in 1966."

Miller (1979: 668) also argues that what is shaking the legal profession is not the class action itself, but rather the "big case" phenomenon which transcends the class action. Because the incentive structure for plaintiffs' and defendants' lawyers as well as judges seems to favor big cases, Miller suggests the trend to big cases would have occurred even if the class action language in Rule 23 had not been changed. While Miller's arguments may be true, the class action lawsuit (complete with the 1966 changes) gave a powerful vehicle to express those changing societal norms.

Miller correctly points to Congress as another source of the changing nature of class action suits (as mentioned above). Congress passed many bills in the late 1960s which were conduits for social change via the class action lawsuit, including the Truth in Lending Act, the Fair Credit Reporting Act, and the Magnuson-Moss Warranty – Federal Trade Commission Improvement Act (Miller, 1979: 675). While these may not have been initially intended to facilitate class action lawsuits, they were quickly identified as a vehicle for both social change and rent extraction. In some cases, however, Congress was explicitly trying to remedy perceived deficiencies in the class action lawsuit. As Miller notes, the Truth in Lending Act was subsequently amended to 1imit damages in class actions under that Act to the lesser of $500,000 or one percent of the creditor's net worth. In this case, according to Miller (1979: 683), it was clearly Congress' intent to maintain the class action vehicle itself, while limiting the overall damage (rent extraction) that could occur to the defendants involved.

While Congress was making changes affecting class action lawsuits, they were not alone. The Supreme Court, in the *Eisen* case of 1974, ordered that plaintiff attorneys had to pay the costs of individual notification to all pro-

spective class members. This decision was seen by some as limiting the class action suit. If the lawyers were forced to pay the significant notification fees up front, with no certainty towards recovery, it was thought that only very large firms would have the capital necessary to fight with class action suits (Hensler, 2000: 20). This, in effect, was potentially a change in the "property rights" established in 1966. Perhaps more importantly, the *Eisen* decision also eliminated judicial review of the underlying case prior to class certification. This was an important part of the initial impetus for change, which would hopefully reduce the abuse of the system. As Kaplan (1967: 390) states, "The new provision (rule 23 changes of 1966) invites a close look at the case before it is accepted as a class action and even then requires that it be specially treated."

While all this was going on, demographic changes in the legal profession were also impacting the class action field. According to Miller, the no-fault principle reduced the need for lawyers in such areas as auto accidents and domestic affairs. This leads to a transfer of lawyers to potentially more remunerative fields, such as the "growth industry" of class action lawsuits (Miller, 1979: 675). In addition, Miller notes the tremendous increase in total law school graduates during the 1970s. All of these new lawyers have to engage in some legal practice, and the growing opportunities in class action lawsuits seem a likely destination for some of these graduates.

4. Empirical analysis

While one would a priori expect the legal rent extraction hypothesis to closely fit the "bet the business" mass tort cases, our initial investigation will examine securities class action suits – for two reasons. First, if it supports the rent extraction hypothesis, a general theory of legal rent extraction would be more compelling towards the general theory of rent extraction, since mass tort class action suits would be more likely to settle (due to possible bankruptcy). As Priest (1997: 521) notes, "The single most salient feature of the modem mass tort class action is the extraordinary power that derives from certification of a class alone." Priest (1997: 522) adds,

> "Commentators unanimously concede that virtually every mass tort class action that has been successfully certified has settled out of court rather than been litigated to judgment. For any subset of cases, uniform settlement and zero litigation is an extraordinary empirical fact, neither predicted by nor consistent with *any* (emphasis in original) current economic model of litigation and settlement. It is reflective of the huge

> uncertainty and, therefore, the risk that attends judgment of a mass tort claim by a lay jury."

However, in most cases of securities class action status, defendants are not forced to settle because of "bet the farm" consequences; it is simply more cost effective to settle than to fight.

In addition, as mentioned above, public interest explanations require the shareholders to benefit from the suits. If rent is extracted, however, and not returned at the culmination of the suit, public interest explanations are less compelling. It may be asserted that many of the securities suits are to support a particular set of shareholders (such as those that bought the equity in some period of time). But if it is a true public interest story, it should also benefit other shareholders – since it will ostensibly lead to changes in behavior that improve shareholder value in the future.[7]

One can statistically test whether class action lawsuits are being used for legal rent extraction using event study methodology.[8] A threat of rent extraction (announcement of a class action lawsuit) would result in an initial drop in market capitalization. While it would be preferable to use actual class certification, it is likely the market would anticipate the probability of actual certification and most price action would occur upon the initial threat.[9] Thus it seems more appropriate to use the first reported date of a class action as the event to study. Announcement of settlement would require that market capitalization not return to its original level – either go up by not as much as the original drop or not change at all, reflecting the rents that were extracted. Testing of the rent extraction model assumes that stock markets are efficient and that prices reflect the present discounted value of future cash flows.

5. Hypotheses

Analogous to the political extortion discussed by McChesney, public interest explanations may lead to threats levied against businesses that are subsequently retracted. However, the stockholder should be no worse off than originally, if the public interest story is to be accepted. However, under the public choice rent extraction explanation, we should find that some wealth has been extorted from the stockholder. Following Beck et al., four hypotheses are proposed to test for legal rent extraction. The first three hypotheses are consistent with the rent extraction explanation, while the first and the fourth are consistent with a public interest perspective.

Hypothesis I: Upon market recognition of a legal threat, the price of a company's stock will drop, reflecting the market's perception of lower future

cash flows. This results in an abnormal negative stock return during the event period (defined below). This hypothesis is required for either the public or private interest explanation (explaining the subsequent retraction).

Hypothesis IIA: A retraction of the legal threat will not affect the stock price of the company in question; the stock price will reflect a normal return. This hypothesis is the strong form of rent extraction, with the retraction having no effect on the stock price due to 1) the litigant was able to extract all the rent or 2) the market believed that a payoff was certain (at the time of the original threat), and the threat would not be carried out.

Hypothesis IIB: A retraction of the legal threat will result in an increase in the stock's price, an abnormal high return. However, the increase will not be as great as the initial decrease, reflecting the rents that were successfully extracted. This is the weak form of rent extraction.

Hypothesis IIC: A retraction of the legal threat will result in an increase in the stock price of the company in question, with the increase at least offsetting the initial decrease. This hypothesis supports the public interest view.

6. Data and methodology

To test the rent extraction theory, we acquired data on unexpected legal threats. Following the methodology of Beck et al. (1992), we examined the public records for separate incidents of class action lawsuits filed against publicly traded companies due to decreases in the price of the securities. Although most class action securities lawsuits lead to settlement, we needed to find cases that had already settled, to test both the effects of the initial threat, as well as the retraction. The initial identification of class action lawsuits is the Securities Class Action Alert, a monthly newsletter which summarized securities class action lawsuits.[10] From these cases, we searched both the Lexis/Nexis database as well as the Dow Jones interactive business news section to identify companies that had been sued via the class action lawsuit and subsequently settled. In addition to these sources, National Economic Research Associates (NERA) provided an email list of companies which had settled class action suits. From this review, we were able to identify 30 separate cases to investigate. The only requirements for inclusion in our analysis were that the company had sufficient data points for an event study (many initial public offerings (IPOs) did not meet this criteria) and were listed on a stock exchange for both the threat and the retraction period (some companies subsequently went bankrupt and/or were delisted from the exchange prior to

settlement). A list of the companies with the threat date and retraction date is in Appendix A. The source of the stock market valuations was the Center for Research in Security Prices.[11]

The date used for the initial threat was the first publicly reported discussion of a securities class action lawsuit, or the actual date it was filed, whichever occurred earlier. Given efficient markets, this should ensure that the market would quickly incorporate the threat into the stock price. For the threat retraction date, we chose to use the first date where an initial estimate of the proposed settlement value was included. In most cases, this would be the result of a company announcement, significantly prior to an actual court approved preliminary or final settlement. In many cases, the final actual value would be different from that initially announced. Nonetheless, it seems likely that markets are able to include a risk factor for the probability of final settlement, especially since the initial agreement did indicate a range that was acceptable to the litigants. In a few of the cases, we did not find an announcement from the company, and instead used the preliminary court settlement date.

To empirically test the theory of legal RE, we estimated the following equations:

$$\begin{aligned} \text{Return}_{it} &= \beta_{1i} + \beta_{2i}\text{S\&P}_t + \beta_{3i}\text{Threat}_{it} + \beta_{4i}\text{Retraction}_{it} \\ &+ \beta_{5i}\text{S\&P}_t\text{Threat}_{it} + \beta_{6i}\text{S\&P}_t\text{Retraction}_{it} + \varepsilon_{it} \qquad (1) \\ \text{Return}_{it} &= \beta_{1i} + \beta_{2i}\text{S\&P}_t + \beta_{3i}\text{Threat}_{it} + \beta_{4i}\text{Retraction}_{it} + \varepsilon_{it} \qquad (2) \end{aligned}$$

where Return_{it} = day t continuously compounded return accrued by holding common stock in company i;
$\text{S\&P}_i$ = day t continuously compounded return of the S&P 500 index of common stock;
Threat_{it} = threat dummy variable for company i, equal to 1 during the period in which the threat is issued and 0 otherwise;
Retraction_{it} = retraction dummy variable for company i, equal to 1 during the Period in which the threat is retracted and 0 otherwise;
ε_{it} = stochastic disturbance term, independent and identically distributed normal with mean 0 and variance σ_i^2 across time for each company i;

For both equation (1) and equation (2), the coefficients of interest are β_{3i}. which represents the change in the rate of return for company i when the threat of a class action lawsuit is issued, and β_{4i}, which represents the change in the rate of return for company i when the threat is retracted. Note equation (1) differs from equation (2) in that it includes cross product terms.

These terms correct for any systematic change in risk relative to the S&P 500 during the threat and retraction periods. If there is no systematic change, the inclusion of these terms would reduce the statistical power of hypothesis tests performed on the coefficients of interest, β_{3i} and β_{4i}. However, if systematic change in risk is present, the omission of these terms would cause the coefficients of interest, β_{3i} and β_{4i}, to be statistically biased and inconsistent. For this reason, we estimate both model specifications.

For each company i, we estimated equations (1) and (2) on data gathered from 200 days before each threat date as indicated in Appendix A through 10 days after the threat was retracted. As Beck et al. (1992) summarized, current literature suggests any changes in stock prices based on new information are quickly reflected after the change in information, with most of the change occurring within fifteen minutes of the announcement. We are therefore confident that any abnormal activity would safely be captured by even the shortest event window we estimate, (– 1, +1). We also estimate equations (1) and (2) for a (–5, +3) and a (–20, +10) event window to guard against possible error specifying the event dates.

To test whether or not the change in rate of return across all companies is statistically significant and of the expected sign, we compute

$$\mathrm{T_dZ} = \frac{1}{\sqrt{30}} \sum_{i=1}^{30} \frac{\hat{\beta}_{3i}}{\hat{\sigma}_{\hat{\beta}_{2i}}} \tag{3}$$

for the threat, and

$$\mathrm{R_dZ} = \frac{1}{\sqrt{30}} \sum_{i=1}^{30} \frac{\hat{\beta}_{4i}}{\hat{\sigma}_{\hat{\beta}_{3i}}} \tag{4}$$

for the retraction, where d represents the duration of the event window.

7. Results

The results for the 30 cases studied are shown in Tables 1 and 2 below. Table 1 shows the results of the threat as calculated by equation (1), and Table 2 shows the results of the retraction, or legal settlement as calculated by equation (2).

As seen in Table 1, the change in daily rate of return when the threat of a class action lawsuit was issued is negative and highly significant across both model specifications and all three event window durations, all well above the 99% level of significance. We found that most of the individual firms had a negative return when the threat of a class action lawsuit was issued, with

Table 1. Threatening actions

	Duration of event period		
	(–20, +10)	(–5, +3)	(–1, +1)
Equation (1)			
% of cases negative	70	73.3	70
TZ	–6.063*	–6.425*	–6.501*
Equation (2)			
% of cases negative	66.7	70	76.7
TZ	–6.018*	–6.847*	–6.746*

*Statistically significant at a 99.9% level of significance

Table 2. Threatening actions

	Duration of event period		
	(–20, +10)	(–5, +3)	(–1, +1)
Equation (1)			
% of cases positive	43.3	56.7	50
RZ	0.001	2.156*	–.022
Equation (2)			
% of cases positive	43.3	60	53.3
RZ	–.370	2.288*	0.596

*Statistically significant at a 98% level of significance

around 70% of the cases in each treatment being negative. In short, we find the data consistent with Hypothesis 1 as described above.

Given the strong results contained in Table 1, it appears that on average a statistically significant reduction in return is observed when the threat of a class action lawsuit is issued. Whether our data is more consistent with legal rent extraction or a public interest hypothesis is determined by whether or not a significant increase in return of sufficient size is observed when the threat is retracted. The statistics of interest are reported below in Table 2.

In the (–20, +10) and (–1, + 1) event period specifications, RZ is not significantly greater than zero. These model specifications are consistent with Hypothesis IIA, the strong form of legal rent extraction: The rate of return was abnormally low when the threat of class action law suits was issued, but there was no appreciable recovery when the threat was retracted. Note that for both estimated equations calculated using the (–5, +3) event window, a

Table 3. Sum of threat and retraction

	Duration of event period		
	(–20, +10)	(–5, +3)	(–1, +1)
Equation (1)			
% of cases negative		63.3	
TRZ		–2.871*	
Equation (2)			
% of cases negative		63.3	
TRZ		–3.252*	

*Statistically significant at a 99% level of significance

statistically significant increased rate of return was observed upon retraction. To differentiate between Hypothesis IIB and 11C, we calculate a statistic testing whether the initial decreased rate of return exceeds the subsequent increased rate of return, as seen in Table 3.

$$\mathrm{TR_dZ} = \frac{1}{\sqrt{30}} \sum_{\mathrm{i}=1}^{30} \frac{\hat{\beta}_{3\mathrm{i}} + \hat{\beta}_{4\mathrm{i}}}{\hat{\sigma}_{\hat{\beta}_{3\mathrm{i}}+\hat{\beta}_{4\mathrm{i}}}} \tag{5}$$

For both specifications tested, the sum of the initial decrease in the rate of return due to the threat and the subsequent increase upon retraction is negative and highly significant. Given this, we state that both models estimated for the (–5, +3) event window are consistent with Hypothesis IIB, the weak form of rent extraction, in which the increased return upon retraction does not entirely erase the previous decreased rate of return when the threat was issued.

8. Conclusion

The theory of rent extraction can be expanded beyond a model of political extortion to a model of legal extortion. Just as a politician gains a property right (with election) to extract wealth but can be paid not to, the trial lawyer has gained the property right (via changes in the legal system over the last 30 years) to extort wealth via the class action lawsuit. Empirical testing on securities class action lawsuits is consistent with this proposition.

Notes

1. Note that these costs are independent of any actual settlement or judgment against the company, as the company necessarily must expend resources to defend against the suit. The suit may also create uncertainty in the financial markets concerning future profitability of the company, lowering its credit rating and thus increasing costs of finance.
2. As in the silicon breast implant case, Agent Orange, or Benedictin, see Hensler, pp. 107–108.
3. Indeed, in the *Rhone-Poulenc* case (hemophiliacs with HIV tainted blood), the court denied certification since certification might force the defendants "to stake their companies on the outcome of a single jury trial, or be forced by the fear of the risk of bankruptcy to settle even if they have no legal liability." (Priest, p. 533).
4. While we concentrate on changes authorized by the legislature, it is surely true in our common law system that some judicial decisions facilitate rent extraction. Yet even in these cases, the legislature could overrule the judicial systern, if there was enough political support. So in that sense all rent extraction is at least acquiesced to by the legislature.
5. This section borrows extensively from the comprehensive treatment by Hensler et al., and sources identified in their work.
6. But he then argues that the same result would likely have occurred through some alternative (unspecified) legal mechanism with the pre-1966 text (Miller, p. 674).
7. Given efficient markets, if the company had procedures that could conceivably injure shareholder interests, it would be reflected in the price of all shares, not just those previously injured. The logic is if they could do it once, they could do it again. Removal of this ability would result in higher present discounted value of future cash flows and thus a higher stock price.
8. See Beck, Hoskins and Connolly (1992) for an application of this approach.
9. This is especially true since the requirements for class action status (typicality, numerousity, commonality, adequacy, etc, see Resnick, p. 25) are more easily met with securities class actions than with other types (such as mass torts, where damages vary greatly).
10. SCAA, The Authoritative Report on Shareholder Litigation, http://www.irbc.com/
11. Source: CRSP, Center for Research in Security Prices. Graduate School of Business, The University of Chicago 1999. Used with permission. All rights reserved. www.crsp.uchicago.edu

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Appendix A

Table A1. Securities class action lawsuits

Company	Threat date	Retraction date
Hills Stores	24 Aug 1994	30 Sep 1994
IKON	14 Aug 1998	24 Nov 1999
Itron, Inc.	27 May 1997	3 Jun 1999
UCAR, International	1 Apr 1998	14 Oct 1999
Goody's Family Clothing	24 Nov 1993	6 Apr 1993
National Media Corp	9 Jun 1993	20 Mar 1995
PerSeptive Biosystems	27 Dec 1994	30 May 1995
Radius, Inc.	14 Sep 1992	2 Feb 1995
RasterOps	11 Jun 1992	18 Apr 1995
Gensia, Inc.	18 Nov 1994	30 Mar 1995
DonnKenny	12 Nov 1996	7 Oct 1999
Marcum Corp	22 Aug 1994	25 Apr 1996
Porta Systems Corp	8 Apr 1993	30 Nov 1995
Medical Resources Inc	14 Nov 1997	21 Dec 1998
USX	15 Sep 1993	19 Jan 1996
Applied Magnetics	25 Oct 1993	18 Nov 1994
Compression Labs	10 Aug 1992	4 Apr 1995
Employee Solutions	17 Mar 1997	17 Nov 1998
Digital Systerns	4 Nov 1991	14 May 1993
Laserscope	6 Mar 1991	4 Jul 1991
Immunex	3 Apr 1992	9 Mar 1994
NeoRx	25 May 1994	23 Feb 1995
PS Group	27 May 1992	24 Mar 1995
SciMed Life Systems	27 Sep 1991	29 Sep 1994
Anadigics Inc.	2 Mar 1998	23 Jul 1999
Aura Systems	28 Apr 1997	15 Oct 1998
Casino Data Systems	14 Jan 1997	2 Sep 1998
Digital Lightwave	23 Jan 1998	29 Jul 1998
Exide Corp	1 May 1998	14 Apr 1999
Informix Corp	11 Apr 1997	26 May 1999